Select Wealth Management

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Investment Update – March 2018

Prepared by JMIS, investment consultant to Select Wealth Management

Aside from the February turbulence in equity markets, global economic growth should hold up well and inflation should remain low in 2018.

The recent hard economic data and survey evidence suggest that the world economy is growing at a rate over 3% pa and there is enough spare capacity in many economies for the expansion to continue for a while yet.

Meanwhile, although central bankers are reducing their policy support for this growth, they are doing so only gradually because inflation generally remains low. One explanation for the recent slump in equity and bond prices is that investors have become concerned that inflation is about to take off, forcing central bankers to tighten policy more rapidly than previously expected. However, underlying inflation has remained low and stable, even in economies which are closest to full employment.

US

Non-farm payrolls increased by 200,000 in January, following an upwardly revised 160,000 in December, and beating market expectations of 180,000.
The share market reacted sharply downwards at the beginning of February to this strong number accompanied by private sector hourly wages increasing from +2.5% to +2.9%. This very good fundamental economic news was interpreted negatively in the context of a rising risk for inflation, and therefore interest rates. In fact, the jump to 2.9% year-on-year in January, which triggered the market sell-off, was exacerbated by temporary weather patterns and may yet be reversed.

The surge in the Conference Board's consumer confidence measure to a 17-year high of 130.8 in February, from 124.3, underlines that household sentiment has not been knocked by the recent bout of stock market volatility. Instead, it has continued to strengthen, as households begin to see the recently passed tax cuts show up in their pay cheques.

We expect the Fed to raise rates a total of three or four times this year, beginning with a 0.25% rise in interest rates in March.

China

China's January CPI inflation moderated to 1.5% year-on-year and PPI inflation decelerated further to 4.3% year-on-year. Exports growth inched up to 11.1% year-on-year in January, in line with consensus, and imports growth rebounded sharply to 36.9% year-on-year, partially on distortions of Chinese New Year holidays, significantly above consensus.

China has recently proposed removing the two-term limit for the presidency, in a move that would pave the way for Xi Jinping to remain in office beyond 2023 and tighten his grip on power and the economy.

Japan

Japan's economy grew at a slower-than-expected 0.5% annual rate in the December 2017 quarter, as strong exports failed to fully compensate for relatively weak domestic demand. The preliminary data released in February showed that Japan has now managed eight straight quarters of growth, the longest expansion period since the financial bubble of the late 1980s.

The unemployment rate is now at its lowest level since 1993, while January national core CPI (excluding fresh food) was +0.9% year-on-year, unchanged from December.

Japan recorded a turn to trade deficit in January, of ¥943.4 bn, from a surplus in December. However, we note that this often occurs in January due to seasonality and this latest deficit was around 15% narrower than in January 2017.

Europe

Eurozone concerns over the continued weakness of the US dollar were laid bare in a recent set of European Central Bank minutes that highlighted fears that the Trump administration was deliberately trying to engage in currency wars. The account of the ECB's January monetary policy meeting also revealed that its hawkish members pushed for a change in the bank's communications, arguing economic conditions were now strong enough to drop a commitment to boost the quantitative easing programme in the event of a slowdown.

Australia

In mid-February, the RBA reiterated its forecasts for a more positive growth outlook in Australia and a gradual pick-up in wages and inflation. Even so, key uncertainties remain with regards to the amount of spare capacity in the economy, the speed of recovery in wages and the outlook for household consumption.

The RBA will almost certainly leave interest rates on hold at 1.5% at its policy meeting in March and it will probably continue to signal that there is no risk of a near-term rate hike. Indeed, as progress in raising inflation to the 2-3% inflation target is likely to be slow, rates will probably remain on hold throughout 2018 and the first half of 2019 too.

New Zealand

If global equity markets are fearing higher interest rates, as this month's fall suggest, then Australia and New Zealand offer something of an oasis as both the RBA and the RBNZ have recently dropped some heavy hints that they are in no rush to raise interest rates. This does not mean Australian and New Zealand equity markets are immune to any further global weakness, but it may mean that their bond yields do not rise as far as elsewhere; as well, their currencies may weaken.

Summary

While the sudden increase in market volatility in February raises concerns, we do not believe that the bull market in equities has yet come to an end.

The underlying fundamentals of the global economy remain very strong. The synchronised global growth currently underway is the best level of economic activity seen this century. Strong global growth is contributing to the strong upward revisions to forward revenues and earnings for companies around the world.

While core inflation is still contained in much of the world, the continued strength in the labour market in the US has heightened fears that wage inflation there is finally taking root. With the US Fed already on a tightening path and with three to four further rate hikes priced in this year, the market has become concerned about the impact of higher long-term rates on equity valuations.

Higher bond rates reflect a stronger global economy and are typical during the latter stages of an economic expansion. Historically, this is also a period when equity returns can be very strong.

A diversified approach to portfolio construction remains appropriate.

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